RISK MANAGEMENT

EMBEDDING RISK MANAGEMENT IN TAX ADMINISTRATION

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INTRODUCTION

Imagine a friend of yours has given you a direction to his house after you have been out of the country for several years, especially in a city like, hum, Lagos.

When you pass the freeway, drive to the right and go straight. Look for the bamboo club and take the other lane on the left and then go until you pass the hand-pump. There are some houses in the area. Ask for me in the second apartment. If you don't see me, please call me on 07778-7590-2230.

I think it is better you call your friend now!

INTRODUCTION

Note the following seemingly clear but rather vague statements:

- Pay your realty taxes on time.
- Capital allowances are chargeable on assets in the pool at the end of the year.
- Transfer of assets between related parties attracts no capital gain tax.
- Personal deductions are limited to medical expenses except otherwise provided in this code.

How are we to interpret and apply these statements?

INTRODUCTION

Like in every other organization, risk management should not be a stand-alone activity, separate from the main activities and processes of revenue authorities.

Risk management should be part of the responsibilities of all levels of management, from executive management to line management and floor employees.

It should be an integral part of all processes, including strategic planning, project and change management processes.

INTRODUCTION

Risk management helps managers make informed decisions about the operations of an organization.

The value derives from this help is indispensable to achieving the mission and objectives of revenue authorities.

More than ever before, compliance risk management is taking center stage in the daily operations of revenue authorities.

It has yielded unprecedented increase in the level of voluntary compliance.

INTRODUCTION

Embedding risk management into tax administrations involves deliberate steps to gather, analyze and develop knowledge and intelligence from taxpayers and third party data.

The knowledge and intelligence developed can be used to induce voluntary compliance together with other appropriate methods to enforce compliance with tax legislations.

This provides opportunities for tax administrations to trump taxpayers in an ever increasing complex business environment.

INTRODUCTION

Embedding risk management in a revenue authority involves the following activities:

- ❑ Establishing an intelligence framework;
- ❑ Gathering and analyzing taxpayers data;
- ❑ Developing knowledge about taxpayers;
- ❑ Analyzing compliance behavior;
- ❑ Understanding influences on taxpayers' behavior; and
- ❑ Recognizing drivers of taxpayers' compliance behavior.

ESTABLISHING INTELLIGENCE FRAMEWORK

An intelligence framework is a structured knowledge and understanding that allows tax administrations to perfectly predict taxpayers' compliance behavior.

An intelligence is the highest level of knowledge and understanding about a subject matter that allows an individual to make accurate, complete and reliable prediction regarding the subject matter.

ESTABLISHING INTELLIGENCE FRAMEWORK

An intelligence framework is like fitting a jigsaw puzzle together to discover the image that lie behind the puzzle.

By fitting fragmented taxpayers data together, tax authorities can learn a great deal about taxpayers' behaviors in ways that they are able to predict future compliance behavior with reasonable certainty.

Developing an intelligence framework takes great deal of time, effort and resources but the payoffs far exceed those resources.

ESTABLISHING INTELLIGENCE FRAMEWORK

An effective intelligence framework answers the following questions:

- What is happening?
- Who is doing it?
- Why is it happening?
- How is it happening?
- Where is it happening?
- When is it happening?

ESTABLISHING INTELLIGENCE FRAMEWORK – Sample

Unit Level	Information and Intelligence		
Macro level	International trade and commerce	Prices of produce on the world market	Free trade vs protectionism
	Health of local economy	Government regulations	Socio-cultural factors
Business and Micro level	Compliance history and credit rating	Capital structure, liquidity and profitability	Corporate governance framework
	Nature, sizes and complexity of business	Business competitiveness and intensity	Management integrity and operating style
	Business formality and ownership interest	Household income and purchasing power	Level of automation and use of high tech.

GATHERING TAXPAYER DATA

The first step in building an intelligence framework is gathering, grouping and analyzing data.

The first sources of data are those of taxpayers, such as:

- ❑ Business registration;
- ❑ Beneficial owners;
- ❑ Tax registration;
- ❑ Property registration, if any;
- ❑ Tax return records;
- ❑ Financial statements;
- ❑ Court records, if any;

GATHERING TAXPAYER DATA

- Key partners and associates;
- Key customers and suppliers;
- Registered address, contact number and contact person;
- Credit rating and history of compliance with laws and regulations;
- Bank records;
- Scope of operation;
- Major shareholders;
- Previous audit results, if any;
- Board and executive management composition; etc.

GATHERING TAXPAYER DATA

Other sources of data include:

- ❑ Power and utility companies;
- ❑ Other government departments;
- ❑ Company registry;
- ❑ Law enforcement agencies;
- ❑ Other revenue authorities;
- ❑ Foreign governments;
- ❑ Trade associations;
- ❑ Import and export statistics;
- ❑ Industry and market data; etc.

DEVELOPING KNOWLEDGE OF TAXPAYER

Gathering taxpayers' data is not sufficient and provides no benefit to tax authorities.

The data must be grouped, analyzed and structured in ways that provide discernable patterns that explain current and future compliance behavior.

Data must be captured and stored in a format that allows logical manipulations using appropriate data extraction, analysis and matching tools and techniques.

DEVELOPING KNOWLEDGE OF TAXPAYER

For example, annual turnover can be compared with industry average, economic data or those of competitors to uncover possible under declaration of turnover.

Import records can be matched against cost of sales and compared with industry average to determine whether cost of sales is deliberately overstated.

DEVELOPING KNOWLEDGE OF TAXPAYER

Economic data can be compared with cash flow forecast and bank records to determine whether a taxpayer will be able to settle existing tax debts.

Data can also be triangulated. For example, matching data from company registry against property registry, financial statements and tax filings may expose possible tax fraud or money laundering scheme.

DEVELOPING KNOWLEDGE OF TAXPAYER

Accurate, complete and reliable knowledge of taxpayers is indispensable to revenue authorities.

Tax administrations need to build and retain knowledge, skills, expertise and competencies which can be translated to such knowledge and intelligence.

The use of advanced information technology, data warehouse and data extraction, analysis tools and techniques is equally important for tax administrations.

ANALYZING COMPLIANCE BEHAVIOR

As businesses become more and more complex, it is imperative for revenue authorities to adapt and keep pace with new developments.

Understanding taxpayers compliance behavior is not a guesswork. Several indicators of compliance behavior are now supported by robust empirical research.

Both economic and non-economic explanations of compliance behavior have predictive force.

ANALYZING COMPLIANCE BEHAVIOR

Taxpayers adopt a range of motivational postures in their response to the demands of revenue authorities.

The tax system itself, both law and administration can be a shaper of taxpayers' compliance behavior.

Research has identified two broad approaches to the problem of compliance. The first stems from an economic rationality perspective and has been developed using economic analysis.

ANALYZING COMPLIANCE BEHAVIOR

The second is concerned with wider behavioral issues and draws from concepts in psychology and sociology.

Economic factors:

- Financial burden – there appears to be a relationship between the amount of tax owed and taxpayers compliance behavior. For instance, if taxpayer has tax liability that can easily be paid, it may be willing to pay. However, if the liability is large, potentially threatening the viability of the business, the owner may avoid paying at all or may try to adjust the data reported so as to incur a smaller, but incorrect, tax liability.

ANALYZING COMPLIANCE BEHAVIOR

Economic factors:

- The cost of compliance – taxpayers appear to have a number of common costs of having to comply with their tax obligations over and above the actual amount of tax they pay. These include the time taken to complete requirements, the costs of having to rely on accountants and the indirect costs associated with the complexity of tax legislations. These can include psychological costs such as stress that comes from not being certain that they have met all the tax rules or even knowing what those rules are.

ANALYZING COMPLIANCE BEHAVIOR

Economic factors:

- Disincentives – investigations into the impact of deterrents, such as financial penalties and threats of prosecutions, suggest that they may have a time limited effect on compliance behavior of taxpayers. However, those who are compliant want those who are non-compliant to be punished. If the revenue authority does not deter non-compliant taxpayers with heavy penalties and prosecutions, those who are complaint will have disincentives to comply.

ANALYZING COMPLIANCE BEHAVIOR

Economic factors:

- Incentives – giving taxpayers incentives for compliance may have a positive effect on compliance behavior by becoming more compliant. For example, giving a taxpayer an extended tax clearance certificate or special recognition at a national event may induce both compliant and non-compliant taxpayers to comply.

ANALYZING COMPLIANCE BEHAVIOR

Behavioral factors:

- Individual differences – while many taxpayers comply with their tax obligations, some do not. Individual factors influencing behavior include gender, age, education level, moral compass, industry, personality, circumstances and personal assessment of risks.
- Perceived inequity – taxpayers who believe that the tax system is unfair or who have person experience of unfair treatment are less likely to comply.

ANALYZING COMPLIANCE BEHAVIOR

Behavioral factors:

- Perception of minimum risk – if a taxpayer has the opportunity not to comply and thinks that there is only a minimum risk of being detected, he or she will take the risk of non-compliance. The presumably accounts for the greater under-reporting of certain types of income. For example, salary and wage income is highly visible to a tax authority because of third party reporting. However, other forms of income may be mush less visible and therefore subject to more creative accounting.

ANALYZING COMPLIANCE BEHAVIOR

Behavioral factors:

- Risk taking – some people view tax avoidance as a game to be played and won. They like to test their skills in avoiding their obligations and avoiding being caught.

The perceived fairness of revenue authorities is important in inducing tax compliance.

INFLUENCES ON TAXPAYERS BEHAVIOR

It would be impossible, if not pointless to attempt to list all the different factors that go together to influence the attitudes and behavior of taxpayers.

What we can do is provide a model for thinking about those factors, a model that will allow us to categorize the factors in a consistent manner and form to aid our understanding of taxpayers' compliance behavior.

This model is very useful for tax administrations to apply in their setting to understand why taxpayers behave the way they do and for effective and efficient treatment strategies.

INFLUENCES ON TAXPAYERS BEHAVIOR

There are five general categories under which the factors can be grouped:

- Business profile;
- Industry profile;
- Sociological factors;
- Economic factors; and
- Psychological factors.

INFLUENCES ON TAXPAYERS BEHAVIOR

Business profile:

- Structure – sole trader, partnership, company, trust, etc.
- Size and age of the business;
- The types of activities it carries out;
- Focus – local versus international;
- Its financial data – capital investment, profitability, liquidity; capital structure, etc.
- Key customers and suppliers;
- Its business intermediaries; etc.

INFLUENCES ON TAXPAYERS BEHAVIOR

Industry profile:

- The definition and size of industry;
- Major participants in the industry;
- Profit margins;
- Cost structures;
- Industry regulations;
- Working patterns;
- Level of competition;
- Seasonal factors;
- Technology and infrastructure; etc.

INFLUENCES ON TAXPAYERS BEHAVIOR

Sociological factors:

- Socio-cultural norms;
- Ethic background;
- Attitude to government;
- Age, gender and level of experience;
- Educational level;
- Social group; etc.

INFLUENCES ON TAXPAYERS BEHAVIOR

Economic factors:

- Investment;
- Health of the economy;
- Demographic interest rates;
- The tax system;
- Government policies;
- International influence;
- Inflation;
- Market conditions; etc.

INFLUENCES ON TAXPAYERS BEHAVIOR

Psychological factors:

- Greed;
- Attitude to risk;
- Fear and trust;
- Values and philosophy;
- Fairness and equity;
- Moral compass;
- Opportunity to evade; etc.

DRIVERS OF COMPLIANCE BEHAVIOR

There is no easy answer to what influences taxpayer behavior either toward compliance or non-compliance.

Research suggests that several factors combine to cause taxpayers to adopt sets of values, beliefs and attitudes that can be described as motivational postures.

These postures, two broadly non-compliant and two broadly compliant, characterize the way individuals relate to a revenue authority and the tax system it administers.

DRIVERS OF COMPLIANCE BEHAVIOR

- The disengaged - these are people who have decided not to comply. People with this attitude either deliberately evade their responsibilities or choose to opt out. Cynicism about the tax system is usually matched by cynicism about the role of government.

- Resisters – the attitude of resistance characterizes confrontation. The system is seen as an oppressive, burdensome and inflexible. This attitude characterizes people who do not comply but who will if they can be persuaded that their concerns are being addressed.

DRIVERS OF COMPLIANCE BEHAVIOR

- Triers – more positive is the attitude of those who are basically willing to comply but who have difficulty in doing so and don't always succeed. They may have difficulty understanding or meeting their obligations, but their expectation is that, in any dispute, trust and cooperation will prevail.

- Supporters – the attitude here is one of willingness to do the right thing. There is a conscious commitment to supporting the system and accepting and managing its demands. There is an acceptance of the legitimacy of the role of tax officers and belief that they are fundamentally trustworthy.

DRIVERS OF COMPLIANCE BEHAVIOR

It is important to realize that any taxpayer is capable of adopting any of the attitudes described at different times.

It is also possible to adopt all of the attitudes simultaneously in relation to different issues.

The attitudes are not fixed characteristics of a person or group, but reflect the interaction between the person or group and those that impose demands upon them.

DRIVERS OF COMPLIANCE BEHAVIOR

The value of this model is that it contributes to a deeper understanding of taxpayer behavior and lays the groundwork for the development of targeted strategies which encourage the motivation to do the right thing and constrain the motivation to resist or evade compliance.

Understanding the general theory of taxpayers' motivation can help the revenue authority shape and manage its compliance program in a strategic way.

DRIVERS OF COMPLIANCE BEHAVIOR

In the same way, understanding the factors that drive specific compliance behavior is essential to guide the selection of appropriate treatment strategies.

Taking time to analyze compliance behavior assists the tax authority to address the cause of the non-compliance rather than the symptom, thereby achieving the long-term compliance outcome.

DRIVERS OF COMPLIANCE BEHAVIOR

For example, over claiming business expenses or failure to report accurately may be the non-compliant behavior that is observed and needs to be addressed.

However, the driver of the behavior may be the taxpayer's need to increase cash flow in an attempt to remain competitive in the business environment where competitors routinely under-report their business income or deal in cash.

Alternatively, the driver may be the taxpayer's perception that the tax rates are too high and the desire to recoup some money as compensation.

DRIVERS OF COMPLIANCE BEHAVIOR

In a situation such as this, treating the behavior (the symptom) will only have an impact on the affected taxpayer and even then only for a limited period of time.

Moreover, the taxpayer concerned may actually feel hard done to have been singled out for attention when those around get away with the same behavior.

This may in turn simply serve to fuel feeling of resentment to the tax system and provoke further acts of non-compliance.

DRIVERS OF COMPLIANCE BEHAVIOR

Thus, looking for the underlying cause of the behavior and selecting appropriate strategy to address it could account for a difference in outcomes between short-term, isolated compliance or even aggravated non-compliance and long-term sustainable compliance.

It should not automatically be assumed that the target taxpayer is able to change behavior of its own accord. This is the reason why a tax authority must understand where the cause of the behavior problem lies.

DRIVERS OF COMPLIANCE BEHAVIOR

For example, the behavior of the target taxpayer may be to always submit tax returns late (failure to file).

Further analysis and investigation might determine the cause to be third party entities not making necessary information available to the target population in a timely fashion.

In this situation, penalizing the target taxpayer for its behavior is not going to fix the underlying systemic problem.

DRIVERS OF COMPLIANCE BEHAVIOR

A more effective strategy would be to work with the third party information providers to improve the timeliness of their information dissemination.

Good compliance outcomes begin with good legislation.

Law that is clear and unambiguous with regards to its intent and interpretation provides a solid base upon which to build administrative compliance program and compliance risk management.

DRIVERS OF COMPLIANCE BEHAVIOR

Difficult or ambiguous law creates increased opportunities for taxpayers to behave in ways that were unintended by the law.

In many ways, good law underpins the tax authority's ability to deliver procedural fairness in the conduct of its administration.

If taxpayers perceive the law to be unjust and inappropriate according to taxpayers mores then, inevitably, there is an increased risk of non-compliant behavior.

DRIVERS OF COMPLIANCE BEHAVIOR

Tax administration begins with the law in place. The law represents the component of the context or environment in which a revenue authority operates and it is from this environment that we discern the compliance risk associated with the administration of the law.

The challenge for revenue authorities is to administer the law in a manner that sustains taxpayers' confidence in their administration .

DRIVERS OF COMPLIANCE BEHAVIOR

To that end, the manner of administration must be commensurate with the level of exposure to compliance risk.

Any compliance imposition on the community or sub-section of the community needs to be acceptable according to community standards.

In general, the compliance costs to taxpayer associated with administration must be appropriate. Otherwise, it will create dissatisfaction and therefore lead to a decrease in taxpayer compliance.

CONCLUSION

- There are economic and psychological explanations of taxpayers' compliance behavior.
- Tax laws must be clear and unambiguous in regards to their intent and interpretation.
- Tax authorities must be perceived as being fair in administering the laws to sustain confidence in the tax system and its administration.

CASE STUDY

The compliance risk management function in a revenue authority has discovered some significant issues (what may be happening) from taxpayers' risk intelligence analysis:

- **Commercial banks are under-declaring staff payroll.**
- **Several hotels are not recording cash sales.**
- **Several start up businesses are late filers.**
- **Audit adjustments for manufacturers are successfully disputed.**
- **Realty taxes have declined against the previous year.**

In a group of five persons, determine the probable cause(s) (why) for each discovery and possible

Thank You!